THE ECONOMIC SITUATION

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The Bread Machine Just Keeps on Chugging
Will Consumers Continue to Lead the Charge?
What about Interest Rates, Inflation, and GDP?
South Carolina: Slower but Solid

Shoot the Economy One More Time. It's still alive!

After taking six bullets in the body from the Fed's interest rate pistol, the Great American Bread Machine took a deep breath and surged. Was it a dying gasp, or the real thing? Let's look at some numbers and see what they tell us.

Second quarter GDP was the stunner. Economic activity grew at an annual rate of 5.2%, this after a revised 4.8% for the first quarter. Instead of slowing, this baby seems to be speeding up. But wait. We must remember, GDP growth averaged 7% in 1999's second half. Even so, 5.2% is pretty hot stuff. Maybe we should probe a little deeper before concluding the economy is bulletproof.

Real GDP Growth
(Percent Change)

1998	1999	1Q99	2Q99	3Q99	4Q99	1Q00	2Q00
4.4	4.2	3.5	2.5	5.7	8.3	4.8	5.2

What about employment growth?

Through August, the growth of the U.S. labor force averaged 140,000 per month, with the larger additions coming in the earlier months of the year. April saw a decline of 116,000 workers, after adjusting for the hiring of temporary census workers. The weakness continued. July saw the total labor force shrink by 51,000, followed by August's decline of 105,000. This compares with 1999's average monthly growth of 202,000 workers. Things are clearly cooling down a bit on the job front. The old Bread Machine may be hurt after all. What about consumers? How are they doing?

Are Consumers Leaving the Game?

Consumer demand is the main engine that drives the Great American Bread Machine. Will the weaker job market, higher gasoline prices, and higher interest rates move consumers toward the sideline? Consumers are cutting back. August back-to-school sales were weak, and final sales of goods and services grew at just 4.2% in the second quarter, down from 6.7% in the year's first quarter.

But, wait a minute, what about that 5.2% GDP growth rate? How can GDP be accelerating when the pace of consumer spending, which accounts for 80% of GDP, is lagging? The answer? A faster buildup of inventories. If intentional, the inventory increase will help sustain economic growth in the last half of the year. But, if the inventory increases are unplanned and unwanted, then growth will decline in the year's second half.

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Two things suggest consumers may be down but not out. First, real incomes are rising. Productivity gains in the economy have made it possible for firms to give pay increases and still stay competitive in global markets. Higher incomes predict increased demand for goods and services. Second, consumers are whittling down their credit card debt. Higher interest rates matter. A lower level of consumer debt, which means a lower level of credit-card purchases, will fit the current interest rate environment. When the desired level of debt is obtained, lower level purchases will resume.

There is one more unknown to consider. The booming stock market has contributed mightily to consumer net worth. According to the Congressional Budget Office, the value of stock market assets held by households at the end of September 1999 was about $9 trillion higher than it was at the end of 1994. Their research indicates that consumers increase their spending by 3 to 4 cents for each additional dollar of stock-market wealth. The $9 trillion increase since 1994 added about 1 percentage point to growth in consumer spending. Of course, this stock market driven increase in spending was reflected in a much lower savings rate.

Now, the hard question. Will the bulls continue to drive the stock market? Or will the sleepy bears finally awaken and take charge?

I am still betting on the bulls. Why? The interest rate outlook is favorable. Inflation is low. The outlook for corporate profits is favorable. And the Great American Bread Machine doesn't want to die.

What about Interest Rates?

The Fed-engineered interest rate run-up, which had immediate impact on short-term rates, has had an interesting effect on the cost of long-term debt for corporations large enough to issue their own bonds. Corporate borrowing costs first rose and then declined. The 20-year corporate bond yield rose from about 7.2% in June 1999 when the Fed began raising rates to 8.0% in July 2000. It now hovers at 7.5%.

But while the more credit-worthy borrowers sell bonds in world credit markets, firms too small to take their debt to market are noticing a distinct chill in the air. According to a Fed survey of lending officers, banks have raised lending standards significantly. The tightest in 10 years, lending standards are being scrutinized ever closer by bank regulators. Interest rates are higher, and regulations are tougher. Smaller firms face a distinct disadvantage.

As readers of this newsletter know, in an effort to forecast interest movements, I monitor changes in the Producer Price Index and compare those with changes in the yield on the government 10-year bond. Generally speaking, if inflation pressure is easing, yields will be falling, and vice versa. My most recent reading indicates the bond yield is stable; it is not likely to move up or down in the next few months.

The PPI, which has been trending higher since February 1998, is now showing some weakness. In spite of rising oil prices, inflationary pressures seem to be falling. Interestingly enough, the break in pressure seems to have come in late 1999 when the movement in the PPI for finished goods less energy and food—the so-called core inflation index—broke with the all-items PPI. Before that, both indexes were moving higher together.

Slowing, Yes. Recession, No.

The current interest rate picture shows short-term rates rising above the rates on longer-term debt. We have a so-called inverted yield curve. Inverted yield curves are often associated with deliberate actions by the Fed to slow the economy. Tight credit affects the short rates first. This inverts the yield curve. Then, when the economy goes into the tank, interest rates fall across the entire spectrum, with long-term rates falling most.

Economists at the St. Louis Fed use a statistical model based on the shape of the yield curve to forecast the probability of future recessions. Using data from 1960 forward, the model has accurately predicted the timing of six of seven recessions. It has also predicted one recession that never came. What about now? One version of the model predicts a 20% probability of an August 2000 recession. Another version indicates a 10% probability. The low probabilities suggest the timing is not right, at least for now.

What about GDP?

There are no signs of recession on the soothsayers' screens, but there are some adjustments being made to GDP forecasts. The August Blue Chip forecasters predict 3Q2000 GDP growth will hit 3.2% and 4Q2000 will register 3.3%. They forecast GDP growth for the year to be 5.1%, driven primarily by the high second quarter growth and upward revisions of growth for 1999's final quarter. Just for the sake of having a comparison, the Federal Reserve Governors predict GDP growth for year will fall in the range of 4% to 4.5%.

What are the limits of GDP growth? GDP growth comes from an expanding labor force and improvements in the productivity of the labor force. We can safely bet on 1% growth in the labor force. Three percent productivity growth is a safe bet for the long-run average. That gives 4%. In the last 12 months, productivity has grown 5.1%, a 17-year high. That gives GDP growth of better than 6%. That was then. This is now. Will productivity continue to grow at a record pace? Chances are good that productivity growth will exceed 3% in the next year.

The South Carolina Economy

The South Carolina economy is showing the effects of higher interest rates and slower retail sales nationwide. Employment growth has fallen from a January high of 2.8% to 2.1% in July. The declining growth is reflected in the state unemployment rate that stood at 4.0% in July, after having seen an April low of 3.5%.

The housing sector has been hit particularly hard by the combination of higher interest rates and slower employment growth. In July, newly issued residential construction permits, which have been declining for almost a year now, were 22% lower than the year before. Even so, the construction sector is the leader for employment growth, followed by services. Driven largely by job losses in non-durable goods, manufacturing employment continues to decline.

On a regional basis, home sales have fallen more in Greenville than in the Charleston and Columbia market. In fact, the Charleston market continues to be the most vibrant regional market. As shown in the accompanying chart, Charleston's relative vibrancy is supported by strong employment growth.

STATE AND REGIONAL EMPLOYMENT GROWTH (%)

	Feb.	Mar.	Apr.	May	June	July
South Carolina	2.4	2.7	2.4	2.8	2.5	2.1
Charleston	5.2	5.3	4.8	4.9	5.2	5.8
Columbia	2.7	2.7	2.5	3.3	3.2	3.5
Greenville	1.5	1.3	1.5	1.8	1.9	1.8

Source: Bureau of Labor Statistics.

A different regional pattern is seen for retail sales. Since 1991, Greenville has been the largest regional retail market. Until 1996, Columbia and Charleston were almost identical in size. In 1998, Charleston accelerated with surging retail sales. Indeed, Charleston's sales recently have exceeded Greenville's.

To put all this into context, consider the accompanying chart showing the recent record and projections for growth in total personal income for South Carolina, the nation, and two neighboring states. If the projections hold true, South Carolina will outperform the nation, Georgia, and North Carolina.

The state's economy is a bit weaker, but continues to perform at a high level.

GROWTH IN TOTAL PERSONAL INCOME
(Percent growth, nominal dollars)

	1998-99	1999-00	2000-01	2001-02
United States	5.8	6.1	5.5	5.4
South Carolina	**6.7**	**6.2**	**6.3**	**5.9**
North Carolina	5.6	6.5	5.2	5.2
Georgia	7.4	6.8	5.9	5.8

Source: WEFA, June 2000.

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